

Oil Valuation Workshop
Houston, 3-24-99

I. Introduction/Opening Statements

Lucy Querques Denett

- Introductions of participants at table
- Noted this is first of three workshops/comment period had been reopened
- Notes will be made available on internet
- Is an agenda, but will be flexible

Larry Wooden, Shell, representing Interassociation Coalition of Oil and Gas Industry, and Inter-association task force set up by CEOs of majors and independents

- Wants open dialogue/appreciates MMS reopening comment period
- Supports general objectives of the rule
- Wants reasonable value of production at the lease; simplification of royalty payment requirements, including audit; and workable rules that are clear and inherently fair
- Industry has worked together to develop consensus on how to bridge some gaps in the rule
- Has some new approaches to suggest, but willing to discuss alternatives/encourages questions
- Also wants understanding of MMS's assumptions and basis for rule
- Committed to pay every penny of royalty due on production at the lease/it's to lessee's and lessor's interest to get highest value obtainable
- Comments directed to moving process forward

Mike Adams, Louisiana, State Representative

- State position hasn't changed--support index price or clear market price, with appropriate quality and transportation adjustments to the lease

II. Current Agency Views on Proposed Rule

Debbie Gibbs Tschudy

- Provided history of successive proposed rules and public meetings/workshops beginning 12/95 (Jan. '97 proposal, 2 public meetings 4/97; July '97 supplemental proposed rule; 9/97 reopening of comment period on 5 alternatives, 7 workshops 9/97 and 10/97; 2/98 second supplemental proposed rule, 5 meetings; 7/98 reopening of comment period, 3 meetings. However, industry's dialogue was limited because of the oil litigation.
- Detail and rationale on draft final rule provided in August 1998 letter to Senator Breaux from AS/LM (direction the Dept. was heading in final rule)
 - definition of affiliate--similar to definition in current regulations, would issue guidelines on rebuttable presumption of control
 - definition of gross proceeds: similar to current rule definitions but would

- specifically include marketing services and buydown payments.
- two exceptions to use of arm's-length contracts identical to current rule--did not intend to include any additional language in rule about total consideration received or value not being reasonable, but would say in preamble no intention to second guess
- only new exception would be for oil for non-competitive calls (not based on price that would have been paid in competitive environment)
- for oil sold after an arm's-length exchange or transferred to an affiliate, option (applicable for 2 yrs) to either use index price or trace affiliate resale price
- for valuing oil not sold at arm's length, use ANS prices for California with location and quality differentials (as for rest of country)
- for non-arm's-length transactions in Rocky Mt. Region, use benchmarks
 1. MMS-approved tendering program, highest price bid on volumes at least 30% of lessee's field/area production (based on Federal royalty percent and state severance/ad valorem taxes)--at least 3 bids from lessees w/o tendering programs in same field/area
 2. Weighted average of lessee's/affiliates' purchases and sales of volumes equivalent to at least 50% of their field/area production; 50% rationale would make it unnecessary to have comparability criteria
 3. WTI Cushing spot price, adjusted for location/quality
 4. ask MMS to approve alternative valuation method
- rest of country, non-arm's length
 - applicable spot prices
 - differentials from own data or data from MMS based on proposed Form MMS-4415
 - MMS wanted to eliminate 4415, but found based on comments that some companies would not have sufficient data for location differentials otherwise
- transportation allowances permitted for arm's-length and non-arm's-length situations:
 - arm's length transportation agreements
 - non-arm's-length: actual costs based on same method as current rule, but no FERC tariff exceptions (offshore no FERC jurisdiction for movement to first adjacent state, and tariffs exceed actual costs)
- still working on subsea tie-in guidelines (Lucy: MMS senior management meeting on this later this week, guidelines could be published as early as a month from now.)
- Assistant Secretary may issue binding valuation determinations

Sara Tays, Exxon

- volume weighted prices wouldn't include quality adjustments?

Debbie Gibbs Tschudy

- yes they would; but there would be no other criteria for comparability

Fred Hagemeyer, Marathon

- have there been any changes in MMS thought process since August 1998?

Lucy Querques Denett

- no--essentially on hold until now

Mike Coney, Shell

- why hasn't MMS provided responses to all comments received? Could MMS publish something to state what MMS' views are/put on internet while dialogue continues?

Lucy Querques Denett

- that's in the final rule that we couldn't publish because of moratoria. Minutes of past meetings are, and for current meetings will be, on internet, We can discuss in these sessions our rationale on what we have done so far.

Peter Schaumberg

- what we have now is not our final view on the comments; we are still taking comments and considering what our final position is. Wouldn't want misleading documentation on internet.
- note decision last week in Shell v. Babbitt on tariffs on OCS pipelines--copies available

Larry Wooden

- when will subsea gathering guidelines be available?

Lucy Querques Denett

- perhaps in a month

Fred Hagemeyer

- summary of "industry" views on rule. Not easy to speak as "industry"--despite differences among companies, "industry" has tried to bring together common comments.
- personal opinion--with 20/20 hindsight, perhaps industry should have taken more direct, specific involvement earlier in the process. On the other hand, '97 MMS workshops didn't necessarily have as much give-and-take as possible.
- provided handout ("Oil Valuation Overview")
- noted structural changes over the past 2 years (e.g., mergers)
- some definitions from 1988 rules that stay the same take on added significance given changes on

structure of the rule

- striving for lease value of production

- noted interconnectivity between different elements of the rule (affiliate/arm's length/allowances/comparables/binding determinations/second guessing); look at these issues as package if possible

- start by looking at arm's length comparables, trying to address MMS/State concerns

III. Discussion of Key Issues

1. Non-arm's-length Transactions

- Dan Riemer, Marathon

- **Comparable Sales Model** (see handout)

- goal is value at the lease

- comparables should be first benchmark/guideline

- builds on MMS benchmarks in Rockies--could be expanded to other areas

- simpler than netback

- could eliminate need for 4415

- Hugh Hilliard/Lucy Querques Denett/Debbie Gibbs Tschudy

- question as to whether there are many comparable sales to rely on, even in Gulf of Mexico. What kinds of sales are there? Are there contracts available? How would weighted average be calculated?.

- Dan Riemer

- few comparables may have been true in early '90s, but less true today

- combination of bid-out (tendering) and third-party outright sales proposed

- Fred Hagemeyer

- point is to put burden on lessee to come up with information on contracts

- spreadsheet ("black box") to show what contracts were used, from what fields, etc., with contracts to back it up.

- use company's own contracts (not from other companies)

- weighted average of all contracts (tendered and sold outright otherwise) from the same field or area, with location/quality differentials (not just weighted average of "comparables"). However, agreeing on a field or area may be an issue.

- Tom White, Walter Oil and Gas

- his company is marketing company purchasing oil from affiliated producer and

- others
- in the past, it was primarily just independents who sold production at the lease
- more independents now in Gulf
- larger companies also have begun programs to offer oil on an open solicitation basis at the lease. Amount of arm's-length sales increased about 5 years ago.
- momentum for more sales at the lease (bid-out programs and outright sales), largely driven by desire to establish basis for royalty valuation
- big shift has been by the majors

Lucy Querques Denett

- Given shift in market, do current regulations with benchmarks work?
- Remember lease terms say "production FROM the lease," not "AT"
- Is there flexibility in the 20% of production number in the proposal and in the number of outright sales?

Fred Hagemeyer

- conceptually, this proposal fits into the current regulations in some ways, but comparables perhaps not well defined
- some in industry think 3-10% is enough to establish value--so movement up to 20% is higher than they think is needed, but can discuss it further
- what is important is that it is a third-party sale; shouldn't be so important whether bid-out or contract sale.

Peter Schaumberg

- 20% of LESSEE'S production? How do you deal with multiple lessees on same lease--could values be different?

Fred Hagemeyer

- Lessee's production. Values can be different, as under current regulations.

Tom White

- Co-lessees may market differently with different prices.

Peter Schaumberg

- We understand that in relying on arm's-length contracts that values will be different. But when using external arm's-length factors to value non-arm's-length sales, we don't see why it should vary from one lessee to another. Assume both co-lessees selling non-arm's-length, does it make sense to have different values?

Wendy Daboval

- Fundamental premise is that arm's-length sales are used to value non-arm's-length sales. Arm's-length value at lease is better surrogate than arm's-length value. Agrees that it is a substitute, but it is better than the alternative.

George Butler

- Even under current regulatory benchmarks, with different parties selling non-arm's-length, the values used may be different—for example, due to different transportation allowances.

Chip Rothschild, Marathon

- Shouldn't be a concern to mix term and spot sales, as long as arm's length. Just like done for major portion today.

Wendy Daboval

- should include all arm's-length sales. Whether bid-out or individual negotiations shouldn't matter, given that industry always will have incentive to get higher price.

Debbie Gibbs Tschudy

- MMS is concerned about bid-out programs; appear to be for purpose of creating royalty value. Not putting own oil at risk, and may not have incentive to get highest price. Concerned about administrative burden of separate program and approval process. (Concerned about volumes offered for sale—for example, onshore may need as much as 27% to cover state severance and related taxes.) (Mike Adams: Louisiana is 25% combined (1/8 royalties and 1/8 severance tax)). MMS can provide data showing survey of state severance tax rates.

Lucy Querques Denett

- Don't want to find out a few years from now that tendering program, like posted prices in the past, don't really reflect fair market value.

Peter Schaumberg

- What happens if company doesn't sell 20%?

George Butler/Fred Hagemeyer

- If not 20%, then must go to index or tracing.
- industry change to the 20% level was in response to MMS's earlier concerns

Peter Schaumberg

- assume company sells 21% arm's-length at lease, 40% arm's length at market center onshore, and 39% non'arm's length. Should MMS only look at the value of the 21% in valuing the 39%?

Fred Hagemeyer

- Lessee may include outright sales onshore, so the 61% might be used to value the non-arm'-length portion. The onshore sales would not necessarily be excluded in determining value. This is an area for further discussion/refinement.

Debbie Gibbs Tschudy

- Proposing 2 options only (comparables and index), for all U.S.?

Fred Hagemeyer

- Yes

Wendy Daboval

- Considering Peter Schaumberg's question, industry will look again at the issue of including the sales not at the lease

Fred Hagemeyer

- Industry proposal would have to deal with what is comparable (e.g., whether to include the 40%)
- administration easier if very clear about what is comparable.
- possibility of doing a desk-audit type process.
- company would bring proposal for MMS approval in each case

Mike Coney

- Not suggesting that every tendering program would have to be pre-approved--instead MMS could set out criteria for tendering programs.
- If volume centers around severance tax, how much of federal production has such severance tax?
- perhaps standard would be putting oil at risk and would vary state to state.

Lucy Querques Denett

- Why doesn't industry want to use spot prices, when other programs appear more administratively complex? Are the values that different from other methods?

George Butler, Chevron

- proposal is that if the company chooses to engage in a certain amount of arm's length dispositions, then that company would have the certainty (more certain than netting back).
- but companies not required to use tendering or similar programs—could use index pricing.
- premise is that arm's-length dispositions at the lease are the best measure of value, where available.
- addressing Lucy's earlier question about continuing to use the 1988 rules: now, 10 years later, industry finds that its understanding of benchmarks is much different from MMS's. Issues involving data available to company about sales by others from the same field or area (and how to define those), and whose responsibility it is to gather the data; MMS has gone directly to 4th benchmark if industry doesn't have data.
 - make it clear that it is only the data for sales by THAT lessee used for the benchmark
 - have less uncertainty
 - industry also thought buy-sell agreements were arm's length—beginning with the interagency task force and continuing with this proposal, MMS says they're not. Under its new proposals, industry would concede that buy/sells should not be treated as if arm's length

Erasmo Gonzales

- What's wrong with index?

Dan Riemer

- Lease market is not a spot market--it is more long term
- Certain administrative costs associated with sales at the lease are not incurred at a market center, and spot prices aren't available at the lease—barrels at market center can get a spot price, lease barrels can't
- Have to make adjustments to get back to the lease, but adjustments won't capture term difference.
- If lease production sold to a number of market centers, how do you choose which one to use?
- Anytime theoretical rather than actual adjustments are used, inaccuracies are introduced

Mike Adams

- There are many onshore locations where sales can be made; can get to market center various ways.
- All the information is available on transportation costs to market centers.

- So can make “standard” quality and transportation adjustments.

Dan Riemer

- As long as you have open access and published tariffs, this can work. But complications can arise with barge and truck transportation or any time you have disruptions/constraints in the normal transportation market.

Mike Adams

- Any allowances necessary to move production to market center should be permitted

Dan Riemer

- There are significant differences between MMS and industry viewpoints on costs permissible (“at” v. “from” the lease)

Peter Schaumberg

- Has industry done a comparability test between value at the lease and value at index?

Dan Riemer

- there are wide swings; depends on the adjustments that are allowed.
- depends on whether allowing actual costs or tariffs

Fred Hagemeyer

- Some factors are difficult to quantify.
- Number of purchasers affects demand side.
- Industry has not run numbers to answer the question directly. Difference fluctuates, could range from pennies to perhaps 20-30 cents or higher.

Mike Coney

- Number would vary company to company.
- But is it valid for MMS to value production away from lease?
- MMS should be looking for solutions for the largest number of people possible-comparable sales easier than tracing production, and easier to audit.
- Also sets aside the “duty to market” issue--doesn’t enter equation if use comparables--no need for tracing and allowances.
- Looking for administratively simple method.

Lucy Querques Denett

- Question is where the true market is. If there is no market at the lease, then we look downstream.
- MMS is concerned about creating an artificial market at the lease where there is no such market.

Mike Coney

- Does MMS have a gross proceeds or market value lease?

Peter Schaumberg

- Federal leases are both gross proceeds and market value, where gross proceeds are the minimum.
- '88 regulation commit MMS to accepting gross proceeds in arm's length situations, but that is not required by the lease.
- Threshold issue of whether you include non-arm's-length sales at places other than at the lease--using all sales is better.

Sara Tays

- Index problem is that it doesn't result in a lease value. Thought we agreed on that. So what's wrong with the lease market? Why do you think these programs are created to pay royalties? Note that many choices are made to sell arm's length regardless of need to establish royalty value. Would expect market to look at any barrel as a barrel, regardless of type of program. Arm's length sales are included in the mix because industry is paying on those anyway. Maybe not as big an administrative burden as MMS envisions.

Debbie Gibbs Tschudy

- Our more recent audits show few arm's length sales at the lease.
- We think that an index program is simpler, since most companies have exchange agreements with differentials and transportation costs can be calculated.

Wendy Daboval

- All of industry agrees that it is not simpler.

Mike Adams

- If selling way out in the Gulf, there may be few buyers. May be a lower price.

Fred Hagemeyer

- That reflects the value at the lease.

Lucy Querques Denett

- What about concern about limiting the number of bids?

Tom White

- That hurts MMS by limiting the number of bidders.
- Walter is active in the market buying from the majors.
- Make no distinction as to whether the oil is part of a tendering program or not.
- Walter will adjust price to reflect the risk that Walter accepts for selling the oil downstream (which brings up the duty to market issue).
- If done at an open and competitive market at the lease, that is the best way to value.
- Doesn't think competitors do anything differently.
- Will buy from anyone as long as can make money downstream.

Lucy Querques Denett

- MMS doesn't want to create a market that doesn't exist.

Dan Riemer

- Market exists at lease regardless of whether a tendering program exists

John Northington

- Could some companies w/ tendering programs describe them, and their reasons for them?

Break

Peter Schaumberg

- Reminder: during the breaks please don't corner MMS folks to provide comments individually. Comments need to be addressed to the group as a whole.

Lucy Querques Denett

- Shell/Texaco will describe their tendering programs. And continue to discuss industry's comparable sales model?

Ronnie Martin, Texaco

- Nationwide tendering program; began in 1991.
- Usually send out to about 30 potential bidders and get half back.
- Convinced that they get the highest price.

- Administratively very efficient.
- For offshore, usually get 15-20 bidders, NM about 15, 5-10 for Wyoming and Colorado.
- Art is to design bid package that attracts interest (not too large to eliminate small bidders).

Dan Riemer

- Have to tailor bids to the specific markets.
- How you define the grades and geographic markets makes a difference.

Peter Schaumberg

- How is oil moved after purchased?

Ronnie Martin

- Bidder has the responsibility to move the oil.

Larry Wooden

- Purpose of Shell's tendering program (developed about 1-1 ½ years ago) is to maximize the value of production at the lease.
- Equilon has right of first refusal on 85% of oil bid (and usually gets it), but has to match highest price. 15% is just pure competition.
- Shell E&P is operated as a separate company--compensation based solely on E&P and not on Equilon.
- Purchaser has the responsibility for transportation.
- Anyone permitted to bid, as long as they meet requirements.

Peter Schaumberg

- If Shell could get more money selling onshore, would it do so?
- Do you sell some oil onshore?

Larry Wooden

- Probably would, considering transportation, etc.
- Not sure if any is sold onshore.

Tom White

- Might have to sell some newer grades onshore--probably an exception.

Hugh Hilliard

- How do purchasers negotiate for transportation from producer-owned pipelines?

Ronnie Martin

- Texaco E&P doesn't own pipelines; Equilon does.
- Purchasers may have to negotiate with Equilon or Equiva.

Tom White

- When buying oil, have to negotiate with all necessary pipelines.
- Assume they get the same price for transportation as competitors.

Erasmus Gonzales

- When you (Walter) buy oil from Shell or Texaco, is it resold to them?

Tom White

- It could be. Want only to get the best price possible from bona fide purchasers.

Dan Riemer

- While Walter or others may buy from a company and then resell to another company related to the original seller, there is no "reciprocity"—entirely different personnel and companies involved. There is no overall "business relationship".

Peter Schaumberg

- If someone can make money buying some of your oil and reselling, why aren't you making that money?

Larry Wooden

- Depends on other investment opportunities and whether Shell E&P wants to invest more money to try to capture the margin.

Debbie Gibbs Tschudy

- Aren't you capturing the margin on the 80% not bid out? (Because goes to refinery and profit made there?)

Dan Riemer

- No guaranteed profit associated with tendering.

Tom White

- Margins are very thin, and many marketers lose money.
- The prices received under bid-out programs are very high.
- Not a guaranteed profit.

Dan Riemer

- Marathon has no tendering program, but does sell a fair amount of oil at the lease.
- Marathon buys some oil from other producers at the lease, and it is a competitive market.
- Sometimes middleman sells oil to refiner at the same price as the price at the lease under the bid-out program.

Fred Hagemeyer

- Marathon has lots of outright sales at the lease, indicating that there is a market there.

George Butler

- Peter's question seems to be why isn't producer selling downstream.
- Troubling question; MMS position that spot prices should be used implies that all oil is sold at market centers.
- A lessee is nothing more than a lessee and has no duty to engage in practices (with real costs and risks) to enhance the market value beyond the value at the lease.

Lucy Querques Denett (these items put on flip chart)

- Recognize that all oil doesn't move to market center
- Need more information on industry proposal--important to us that onshore arm's length sales (if any) be weighted in.
- Important to define what counts in the arm's length sales for purposes of determining value of non-arm's-length sales
- Can industry discuss percentage of production--higher than 20% to ensure not just for royalty and severance tax (producer putting its own production at risk)?
- May want to caucus and come back to this later today or by future workshops.
- Also, MMS will bring to DC session copy of analysis of state severance taxes.

Mike Adams

- Concern that some companies could sell small percent outright at relatively low price, use this value for valuing the majority of its production moving non-arm's-length, and take its profits out of the refinery.

Fred Hagemeyer

- Feedback from MMS will help industry to caucus and get back to MMS at future workshop (especially DC) on the percentage and other issues.

Lunch Break

Lucy Querques Denett recap--flip chart (see above)

2. **Binding Determinations**

Chip Rothschild

- See Handout attached
- want to avoid having determinations revisited many years after the fact
- propose to allow lessee to propose a methodology (case-by-case)
- no precedential value
- MMS time limit (180 days)
- Lessee can pay royalties pursuant to methodology until and unless MMS prescribes modified or different methodology (if timely, MMS change goes back to date of proposal)
- subject to normal appeals process, but Secretary or Asst. Sec. could make final for the Dept.
- If MMS does not act within the 180 days, company can pay consistent with the proposal until and unless MMS prescribes modified or different process.
- if approved, payor fulfills royalty obligation as long as it complies with the methodology
- specific language proposed in handout

Peter Schaumberg/Lucy Querques Denett

- What would the effect be if the Dept. fails to issue timely decision? Concern that proposal could be affirmed by a default decision.

Chip Rothschild

- Defer to appeals rule on that.

George Butler

- Previous orders allowed determinations that companies could rely on; sees non-binding guidance as recent MMS policy change
- Support policy that company can ask up front if it has properly interpreted the rules and have that be binding.
- Go back to the way industry thought the process under current rule was to work, but with time limits..
- If MMS gives an order to industry, then the industry can comply with it and not risk someone coming back later with a different interpretation.
- Didn't think these should have to always go up to Secretarial level, but it would be up to Department.

Hugh Hilliard

- Asked about whether other agencies have similar processes and whether duty to act consistently gives these precedential value.

Chip Rothschild/Mike Coney

- Revenue rulings by IRS. They are binding, but they are given little weight as precedent. [See Apr. 18, 1998 API comments--sidebar comment from David Deal.]
- Precedent limited to facts presented to Agency.

Hugh Hilliard/Lucy Querques Denett/Debbie Gibbs Tschudy

- Concerns about issues decided within 180 days at a Division level.
- Not sure that IRS rulings are all that binding.
- IRS decisions are made at a higher level.
- Sometimes MMS learns facts later (on audit) that were not presented and that change our view.

Chip Rothschild

- Industry faces big risks on royalties and potential penalties.
- Only fair that MMS should tell the companies up front how the regulations apply to their facts.

Peter Schaumberg

- Is primary concern liability for penalties?

Chip Rothschild

- Concerned about liability in general.

Jim McCabe, California

- Do you want certainty on numbers or methodology?

Chip Rothschild

- Methodology--numbers change over time, although for independents, need certainty on the royalties themselves.

Gary McGee, Devon

- also want certainty not to have to file reports many years later

Erasmo Gonzales

- 180 days may be problematic--may be a resource issue.

David Deal, API

- "binding" is not necessarily the right word--industry wants something it can rely on until

MMS changes its mind.

Debbie Gibbs Tschudy

- We don't see that many of these--perhaps 12 a year (excluding those just requesting exceptions to certain limitations).

Sara Tays

- add to chart that MMS will provide further thought on whether 180 days sufficient.
- also add that industry may provide more information on other agencies and precedential value.

Mike Adams

- Would methodology change if disposition of oil changed? Would binding determination come back to hurt the company who requested it?

Fred Hagemeyer

- It would depend on how much things changed. Company would have to live by the determination it agreed to.

Erasmo Gonzales

- Problem where there is not a full audit at the time of the determination; difficult to accept an up-front determination based on initial facts.

Lucy Querques Denett

- Problem for us is that industry will know when something changes and will request a new determination, whereas MMS may not know about the change until it audits.
- We will look at this given reengineering and where we want to move the organization.
- Perhaps consider making it clear that it is based only on facts presented, but if on audit we find that the facts are wrong/incomplete, it would be void retroactively.
- Notes that the facts may go to the "environment" in which the company is operating as well as specific numbers.

Chip Rothschild

- May be more of a gas issue. Example on how to value gas that was converted directly to electricity w/o transfer price for gas.
- Dispositions change over time, but shouldn't require full-blown audit; requires understanding of market and specific situation.
- As long as company continues to market the same, MMS approval/determination should

continue

Sara Tays

- Won't reengineering take care of this issue?

Lucy Querques Denett

- Will move us toward seeing these situations much earlier, but won't be in place for about 3 years

Debbie Gibbs Tschudy

- Reengineering will address property specifics; determinations usually more at the policy level. How about determinations void if facts turn out different than presented?

Dave Deal

- Agree that if the facts are wrong then the determination would not be valid.

George Butler

- What are we talking about in terms of facts changing later? Any specific examples?
- Is there a way to address that in this proposal?

Erasmo Gonzales

- Note that an approval was always subject to audit and was not an order subject to appeal.

George Butler

- Even if MMS gives non-binding guidance, isn't there still a timing problem?

Lucy Querques Denett

- Yes, but MMS concerned that a binding determination keeps MMS from making changes even if facts were wrong.

George Butler

- Thought MMS concern was that determinations subject to timing limitations similar to 33-month appeal limit.

Fred Hagemeyer

- Key issue is certainty. Need to define what is different facts as opposed to what is different policy.

Tim Jacquet, CNG

- Independent perspective--accounting rules require balance sheet entries for contingent liabilities.
- Uncertainty about unresolved valuation issues with retroactive effect costs the company in its access to capital markets.

Erasmus Gonzales

- Agreed in principle, but doubted Co. would be required to have an entry for an unidentified liability unless they've been told there's a potential problem.

Mike Coney

- Up to corporate manager under GAAP to determine whether or not prudent to book contingent liabilities that his organization may have identified to him.

Sara Tays

- Since proposed rule allows company to propose methods, probably important for rule also to have provisions for certainty to approve Company proposals

Peter Schaumberg/Lucy Querques Denett

- IRS rules at 26 CFR §601.201(l)(5): "except in rare and unusual circumstances, the revocation or . . . will not be applied retroactively if there has been no misstatement or omission or . . . of facts and . . ."

Back to non-arm's-length discussion

Jim McCabe, California (wasn't here earlier, so get his feedback before moving on)

- Arrived late, so want to state position on comparable sales at the lease
- comparable sales are illusory
- If only way to get to market is through proprietary pipelines owned by the majors, it is not a true price
- Whether due to oligopolistic market or control of pipelines, the price will always be at posted price regardless of whether 20% or more of sales.
- So, the proposal would be the current system.
- Documents show policy of majors never to buy oil at other than posted price.
- But facts show that majors never sell at posted price.

- So it is an engaging idea, but does not seem like a solution for California and perhaps to lesser degree in other areas.

Sara Tays

- Fact situation different in California than elsewhere?

Jim McCabe

- Majors are still there.
- Doesn't think, conceptually, situations different in other markets. Anywhere in the country, if there is a disparity between downstream price and price actually being paid, there is market power being applied.

(Discussion about fungibility of goods, comparisons to other markets (homes, wheat, pork))

- issue of how much of the oil goes to the market center.

Fred Hagemeyer

- Restated that point was to introduce an easily-administered model
- Note that the structure of the market has changed.
- Note that there are restrictions on the program.

Jim McCabe

- Might be willing to accept program if at MMS' option, but less willing to accept option at lessee's price
- Also willing to accept arm's-length price received by independents at posted price who have no choice but to sell at that price.
- But not willing to let majors use as the value for oil they take to refineries the price paid by independents at the arbitrary price that majors set at the wellhead through use of their market power and pipeline control.

George Butler

- Proposal is not to rely on posted prices.
- Proposal modeled on what MMS proposed for Rocky Mtn. area (changing percentages from 30 to 20 and 50 to 20)

Jim McCabe

- But at least in California, posted prices and sales at the wellhead usually the same.

Sara Tays

- Are you saying you don't trust arm's-length prices?

Jim McCabe

- For integrated firms, doesn't believe the market power exhibited results in fair market value; take-it-or-leave-it approach; seller has no choice.

John Munsch

- Note that in California there are some independent refineries and some open market assessments by Platt's.

Jim McCabe

- thinks that such prices in San Joachin Valley are not representative of value--thinly traded..
- still thinks the market is concentrated in SJV.

Chip Rothschild

- Independents should be in position to compete with majors in California.

Jim McCabe

- Market still isn't much more subject to competition.

John Munsch

- Disputes that ANS is the representative price for SJV--also thinly traded (large but few trades), different quality, and not necessarily used by same refineries that run SJV crudes.

Jim McCabe

- Documents show that companies compare CA heavy to ANS; ANS deals supposedly between willing buyers and sellers.

Chip Rothschild

- Why would you value Cook Inlet crude that stays w/in Alaska at the price of ANS as used in California? Would propose price used by Tesoro refinery in purchasing Cook Inlet crude (hypothetical question, since now sold arm's length, but may need to consider in the event that those sales became non-arm's-length. Also consider possible future Federal North Slope production).

3. Adjustments to Downstream Values

a. Transportation

Mike Coney

- Transportation Background (Handout–see attachment)
- 1988 regulations basically address capital recovery; that kind of approach gives different results for similarly-situated companies; thinks that's not what rules or MMS intended.
- proposed rule also treats similarly situated parties differently
- thinks this may not be consistent with OCSLA intent, because (1) it's duty of agency to foster development of offshore production. Development of infrastructure requires substantial investment by 1st party there; if you are the first to put in the infrastructure, you are penalized by being able to deduct less from the royalty value than a third party that comes in later and uses the pipeline; and (2) OCS Lands Act does not allow discrimination on pipelines; current regulations allow discrimination to the favor of the Federal royalty owners' production
- disincentive for lease bonuses–pipeline owner may not bid, or bid less, than someone who gets higher allowances; larger royalty because of lower transportation allowance.
- 1988 regulations adopted tariff as a compromise because of concerns about proprietary non-arm's-length transportation deductions
- by proposing to take tariffs off the table, the MMS disturbs the balance achieved in '88
- Prior to 1988, cost of service on proprietary pipelines was accepted as fair transportation allowance
- would rather avoid the FERC jurisdiction issue which is in litigation and therefore not look to tariffs
- Insufficient to simply allow return of and on capital investment plus O&M.
- Look to deepwater royalty relief regulations which allow for 15% return, whereas our non-arm's length cost regs allow for much less.
- Focus on what is the value of the service provided
- For arm's-length transactions, use those rates
- For non-arm's-length transactions:
 - suggests using comparable rates as benchmark
 - if there is significant transportation by other parties (20% or more) on a given pipeline, then you could use annualized volume weighted average rate
 - believes there is no restriction on pipeline disclosing this information.
 - if <20 % transportation by other parties, then use 2 x Moody's BBB as rate of return, but never depreciate below 10% of capital cost of original line + O&M
- For subsea, need further clarification from MMS on whether transportation or gathering. (See earlier discussion by Lucy Querques Denett.)
- Summary of advantages of proposal (see handout)

Tim Jacquet (CNG)

- Fully supported Mike Coney's proposal; stressed importance of dealing with the subsea

tie-in issue.

Jim McCabe

- Seems anomalous in SJV to give transportation allowances where pipelines are already captive

Mike Adams

- question about the high rate of return allowed
- where producer owns the pipeline, we should only permit deduction based on cost
- integrated company can decide where it wants the profit (e.g., more on pipeline, less for production)

Mike Coney

- to not permit profit would be to assess royalty on the transportation service. There is a marketplace that sets pipeline rates--if producer charges too much for pipeline that it owns, third party shippers will build their own pipelines.

Mike Adams

- Would allow all costs; within an integrated firm, profits can go in all directions.

Mike Coney

- Marketplace regulates transportation. Doesn't understand why pipelines come under such suspicion.

Debbie Gibbs Tschudy

- intent of '88 regs was not to capture value of the service, but rather the actual costs incurred by the lessee to move the oil to the point of valuation.
- MMS is capturing lessee's actual costs in either case (what you paid arm's length or what it cost if you built the pipeline)
- producer sets the rate for the pipeline
- our experience is that there is little third party movement through the pipelines--usually owned by the producers.

George Butler

- Protests were filed by PAPCO co-owners concerning FERC tariff.

Debbie Gibbs Tschudy

- That was rare. Tariffs are not representative of a free and open market and are not reviewed

Mike Coney

- Says fair/free and open situations do occur.

Debbie Gibbs Tschudy

- question about whether such a high rate of return is needed for transportation of reserves that have already been found
- 2 x BBB is more than company's cost of capital--found that cost of capital is on average about the BBB rate.

Mike Coney

- There is lots of risk w/ deepwater pipelines.
- 2 x BBB is less than 15% allowed for calculating deepwater royalty relief.

Lucy Querques Denett

- understands there's lots of technology involved. Not easy, but is easier than exploration and production. Is this proposal just for deepwater?

Mike Coney

- no--similar issues for all pipelines.
- focus is on whether there is a service provided for the royalty owner's share
- disputes that industry should only be able to deduct cost rather than value of service
- looking for common ground

Fred Hagemeyer

- if govt. took in kind, it would have to pay for that service.

Lucy Querques Denett

- If govt takes in kind, regulations provided for payment for transportation based on reasonable cost of transportation and refers to same regulatory provision as is used to determine actual costs under in-value provision.

Fred Hagemeyer

- different situation in onshore leases.

Lucy Querques Denett

- we consistently have based transportation allowances on costs, not value.

Mike Coney

- '88 regs accepted because of tariff exception, which MMS now rejects.
- But there is no statutory basis for MMS to adopt a public utility approach.

Tim Jacquet (CNG)

- even if you adopted public utility approach, BBB is too low for these risky projects.
- even as technology risk gets smaller with more experience, there still is a throughput risk, since producers put in extra capacity hoping for more oil to connect.

Peter Schaumberg

- if industry wants a rate of return floor at 2 times BBB, shouldn't there also be a ceiling?
Concern about interest rates spiking in the future.

Mike Coney

- No; floor is there because after full depreciation, there always should be some return (govt. oil should not be transported essentially for free (just O&M)).
- see no need for ceiling, but can consider (add to chart of issues for future discussion)

Fred Hagemeyer

- What does MMS think about the use of arm's-length tariffs to value non-arm's-length transportation (if 20% or more)?

Debbie Gibbs Tschudy

- need more information on comparability.

Fred Hagemeyer

- For any given pipeline, there may be a number of 3rd-party users. Take the average of these rates.

Sara Tays

- Reason for 2 times BBB rate of return in geothermal?

Debbie Gibbs Tschudy

- Risk of geothermal development, and rate used in netback from electricity. Are oil pipelines analogous to geothermal risk?

Tim Jacquet

- There's always a risk associated with laying pipelines

Chip Rothschild/Dan Riemer

- If BBB rate was all that was expected as a rate of return, pipelines wouldn't be built in future or wouldn't be oversized for 3rd-party transportation.

Erasmo Gonzales

- noted that we're only talking about the Federal royalty share, and we need to distinguish what types of risks we are talking about
- risk on sizing is risk of third party throughput--that risk is covered by the rates charged to those parties, which they are able to use as their actual costs of transportation for royalty valuation purposes

Hugh Hilliard

- Whether MMS would accept 20% may depend on how credible the threat is that third party will build its own pipeline. The higher the percentage of third party shipments, the more credible the threat. May need more thought about this.

Tim Jacquet

- Note that sometimes there are other pipeline projects competing against the producer owned pipeline project.

Mike Coney

- MMS is rejecting sister agency (FERC) judgment that crude oil pipelines will be lightly regulated.

Lucy Querques Denett

- Doesn't see FERC as doing anything with these tariffs in terms of review/approval

Debbie Gibbs Tschudy

- FERC's purposes are different from ours, and FERC tariffs are higher than under MMS's actual cost methodology.
- Action item for MMS to better define this difference (added to chart)

Lucy Querques Denett

- but FERC says it has no jurisdiction over offshore pipelines.

George Butler

- Add action item for MMS to show the data it used to see if BBB rate is indicative of cost of capital. Added to chart.
- How confirm that tariffs higher than actual costs?

Debbie Gibbs Tschudy

- Through audit results—lots of costs related to transportation included.
- Also: in '88 we considered calculating weighted average cost of capital for each company; would like industry reaction.

Mike Coney

- Rejects premise of basing allowance on cost of capital
- Perhaps consider weighted average of cost of service

b. location/quality adjustments

Fred Hagemeyer

- suggest deferring this issue to subsequent workshop on 25th

Lucy Querques Denett

- does anyone else have comments on this?

Jim McCabe

- can develop quality differentials from figures published by majors (gravity adjustment schedules from posted price bulletins)

Mike Adams

- Accept market differentials

4. Arm's-Length Transactions

b. Definition of Affiliate

George Butler (see handout)

- Issue of whether transaction is arm's length or not.
- concept of marketing affiliate under current rules says that resale by marketing affiliate would require using affiliate's proceeds; if not a marketing affiliate, would use non-arm's-length procedures.
- industry assumed that if sales were by an affiliate that is not a marketing affiliate, then the gross proceeds was the payment made by the affiliate to the producer
- Now MMS treats sales by affiliates as sales by a lessee and applies the gross proceeds rule.
- Rebutting the presumption of control is "proving a negative" and very difficult.
- Will MMS share its proposed procedures on rebutting the presumption of control?

Debbie Gibbs Tschudy

- MMS is not treating the affiliate as the lessee
- proposed rule gives the option of using spot or the affiliate's gross proceeds.

George Butler

- proposed guidelines for rebutting the presumption of control
- these apply under current regulations as well as future regulations (which Armstrong letter said would be modeled after current regulations)
- modeled in part on 18 U.S.C. 1810 ??? (Chip)
- Proposed standards in handout. For situations of ownership of 10%-50%, the presumption of control would be rebutted if:
 - affiliated entity can take any relevant action w/o affirmative vote of lessee
 - lessee is a limited partner rather than a general partner
 - lessee is a natural person not related to the fourth degree with the affiliated natural person, then no control
 - lessee's directors on board of affiliated company cannot block any relevant action of the affiliated company, then no control through interlocking directorates

Debbie Gibbs Tschudy

- We are looking at this issue within the agency; MMS will consider the ideas presented here and provide its guidelines after management review

Jim McCabe

- large ownership by one company and other control widely disbursed would constitute control by the one company but would seem to pass under these criteria

George Butler

- If company chooses index, would MMS never have a need to audit the affiliate's books?

Debbie

- Correct.

George

- similar issues arise with respect to pipeline ownership and processing plants.
- this situation (10–50 % ownership) arises more often now than it did in the past.
- need clear criteria so that you will know if you fall in the arm's-length box that makes valuation much easier.

Fred Hagemeyer

- Definition of affiliate is connected to other issues, such as transportation cost deductions and whether arm's-length or not.
- 10% often will be so little control that it should not be considered non-arm's-length
- not fair to party that chooses to invest in pipeline and then cannot deduct as much as someone who did not invest in that pipeline

Lucy Querques Denett

- We'll try to give some feedback on how close our views on this are to industry's (add to chart of action items)

Debbie Gibbs Tschudy

- confirm that industry can accept the current definition of affiliate as long as we come up with acceptable criteria for rebutting presumption of control

George

- agrees
- criteria should be in the regulations, not done by internal policy. Should be subject to public comment.

Other issues

none